Usual Suspects Show Up On Cue to Challenge Fed: Caroline Baum

Commentary by Caroline Baum

Feb. 21 (Bloomberg) -- There comes a time in every business cycle when things look glum and the future even glummer.

The Federal Reserve, usually slow to realize all is not well, starts cutting short-term interest rates aggressively. The real-time economic data offer no sign the medicine is working. Like clockwork, the cries go out: This time is different, interest rates aren't working.

The thing is, they always do. Sometimes it takes longer than others depending on the circumstances surrounding the stall in economic growth or outright recession.

While the characteristics of each cycle vary, the analysis and commentary change very little from one cycle to the next. Yesterday's lament finds new acolytes today: We're never going to get out of this mess.

What follows is a list of the usual suspects -- reasons why the Fed's interest-rate policy can't possibly bear fruit, albeit with some undesirable side effects -- and, naturally, my counterpoint.

1. Interest rate cuts can't do anything about the glut of unsold homes.

To the extent that the Federal Reserve can't affect supply, be it of houses, crude oil or automobiles, that's correct. The Fed operates on the demand side of the economy. It encourages consumers to spend and businesses to invest by lowering the ``opportunity cost'' of holding cash. (The lower the real interest rate, the less consumers forgo when they opt to spend instead of save.)

Counterproductive

Wait a second! Doesn't such a policy run counter to the prescribed treatment plan (increased saving) for the U.S. economy, which has been diagnosed with a bad case of borrowing from abroad to live beyond its means?

Bingo. It's not the first, and won't be the last, time short-run needs take precedence over long-term goals.

2. With credit standards tightening, lowering the funds rate doesn't matter. Banks aren't willing to lend.

Homeowners who are delinquent on their mortgage payments, have lost their homes to foreclosure or have followed the advice of Website youwalkaway.com aren't in a position to take advantage of lower interest rates. Others can, including renters with a good credit history.

In terms of the supply of credit, my bank, Citigroup, Inc., seems eager to lend me money at a fixed or floating rate, provide a home equity line of credit and much more, based on mailings I receive.

Euphemisms

Yes, lending standards have tightened, and that's a good thing because they were non-existent until subprime loans lived up to their name last year.

Some banks have to raise capital before they can lend again. Others are still owning up to losses on assets backed by subprime loans, on leveraged loans they can't sell and on an array of other garbage. Their lingo still reflects a reluctance to come clean.

This week, Credit Suisse Group said an internal review turned up ``pricing errors'' on certain asset-backed securities. Last week, auditors for American International Group Inc. found ``material weakness'' in the insurance company's accounting for credit-default swaps.

Fortunately, economics operates at the margin. Not everyone needs to qualify for a loan for the economy to benefit.

How Policy Works

3. Monetary policy works through the channel of housing, and because that channel is clogged, the Fed won't get any ``traction'' from lower interest rates this time around.

Policy works through the banking system, with the Fed lowering short-term rates, steepening the yield curve and putting some heft back in Banking 101: borrow short, lend long.

Back in the early 1990s, the banks were in bad shape. Low short-term rates and an almost-vertical yield curve (the fed funds/10-year Treasury note spread was almost 400 basis points) provided a juicy incentive, but financial institutions were on a strict diet, with regulators looking over their shoulders. It took a long time for the Fed's time-release medicine to kick in.

The workout from the recent real estate bubble-gone-bust may take even longer, without the equivalent of a Resolution Trust Corp. to expedite the process, taking over failed savings and loans and disposing of their assets. (Son of RTC may yet be needed to handle the volume of foreclosed, unoccupied or abandoned residential real estate.)

``Monetary policy may simply lack traction in the current credit environment,'' Harvard economist Martin Feldstein wrote in a Wall Street Journal op-ed yesterday.

Where have we heard this before?

Steeper Is Better

4. Rising inflation is leading to higher long-term rates, which will put the kibosh on housing. (If you think this is inconsistent with No. 1, you are correct.)

Hooray for rising long rates! If the Fed cut short rates and long rates fell even more, that would be reason to worry. It would imply the demand for credit, as reflected in market rates, is falling faster than the Fed can increase the supply.

An inverted yield curve, with short rates above long rates, is contractionary. A positively sloped yield curve is stimulative. It's the one bright spot amid all the gloom. Eventually it will help the banking system heal.

About two-thirds of the increase in 10-year Treasury yields in the last month has been in the real rate, not inflation expectations. That's better than the alternative.

If inflation and inflation expectations deteriorate further, the Fed will have to demonstrate its commitment to price stability, ``downside risks'' to the economy notwithstanding.

Now there's an outcome for which the usual suspects are unprepared.

(Caroline Baum, author of ``Just What I Said,'' is a Bloomberg News columnist. The opinions expressed are her own.)

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